International Dairy Foods Association
Milk Industry Foundation
National Cheese Institute
International Ice Cream Association

Testimony
on behalf of the

International Dairy Foods Association

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It is my pleasure to provide this testimony on behalf of the International Dairy Foods Association, the Washington, D.C.-based organization representing the nation's dairy processing and manufacturing industries and their suppliers. IDFA consists of three constituent organizations: Milk Industry Foundation, National Cheese Institute and International Ice Cream Association. Our 500-plus members range from large corporations to single-plant operations, and represent more than 80% of the total volume of processed fluid milk products and related cultured dairy products, ice cream and frozen desserts, and cheese produced and distributed in the United States. The membership also includes companies that supply goods and services to dairy processors who are reliant on the overall success of the dairy industry.

In this testimony we hope to convey three important messages.

1. Future dairy policy should attempt to eliminate or at least lessen the market intervention and regional distortions created by current dairy programs while providing a reasonable safety net for dairy producers.

2. Enhanced risk management tools for milk buyers and sellers are needed to allow producers and processors to better manage their business.

3. Working together, dairy producers and processors can create more opportunities for growth throughout the industry.

Future Policy Objectives

Our member companies are anxious to work with Congress to develop dairy policy that will improve market conditions for producers without artificially increasing prices to consumers. We believe this is possible while at the same time lessening the milk price distortions that currently exist from one dairy producing region to another. The multiple, complex dairy programs that are currently in place continue to be a very disruptive force within the dairy industry.

To measure various policy options, our boards of directors have recommended four criteria against which all dairy policy proposals should be evaluated. Any new dairy policy should:

- Be national in scope and minimize artificial enhancements of milk and dairy product prices, especially those that benefit some regions to the detriment of others;

- Provide a safety net for dairy producers that, to the maximum extent possible, does not artificially interfere with market prices;

- Promote the development and use of risk management tools by all segments of the dairy industry; and,

- Be consistent with our country's obligations, commitments and objectives with respect to international trade agreements.

Existing Dairy Policy Needs To Be Replaced

Existing federal dairy policy is clearly interfering in the efficient operation of our competitive dairy markets by inhibiting the dairy industry's ability to adjust to changing economic conditions and new market opportunities. Examples of this include:

- Creating an incentive to import dairy ingredients (MPCs) by keeping nonfat dry milk prices under the dairy price support program at levels which make imported milk proteins more economically attractive than domestically produced milk proteins and stifle incentive for increased domestic production of these products.

- Providing a strong economic incentive to manufacture dairy products for sale to the federal government rather than dairy products which are increasingly demanded by the marketplace.

- Inhibiting the ability of the U.S. dairy industry, among the most cost competitive in the world, from competing globally.

- Driving a bigger farm price wedge between regions, with those areas where most of the milk is used in fluid beverage milk (Class I) and/or nonfat dry milk (Class IV) receiving much greater returns than in areas where most of the milk is used to make cheese (Class III). These distortions have been magnified by dairy policies implemented during the past two years.

- Inhibiting the full use of available dairy price risk management tools by the entire dairy industry.

- Allowing a federal government-sanctioned regional cartel of states to block imports of lower cost milk and fluid dairy products from states which are not included in the cartel.

While some have proposed addressing these inequities by adding more dairy programs on top of those already in place, we do not believe this is the answer. The answer begins with replacing existing federal dairy policy with a national safety net for dairy producers which lessens regional divisiveness and allows markets to function with much less government interference. We will lay out our suggestions of how this can be accomplished, but before turning to our specific policy recommendations, we would like to share our views on existing and proposed policies in a little more detail.

Dairy Price Support Program Is Not The Best Safety Net For Dairy Producers

The dairy price support program provides a safety net, of sorts, by requiring the Commodity Credit Corporation (CCC) to purchase products that are surplus of the market at the prices set by USDA. For most of the 1990's, the market was in relative balance and USDA purchased very little surplus. In the past two years, however, the cost of purchasing dairy products off the market by the federal government has grown to levels not seen in over 10 years.

These purchases have occurred largely because the USDA dairy product purchase prices have gone out of alignment with commercial market prices and USDA took no action to make appropriate adjustments. More specifically, this misalignment was the result of commercial butter prices greatly exceeding the USDA butter purchase price and commercial nonfat dry milk prices sitting at the USDA purchase price for this product. The consequence is that even when producer prices were relatively low on average across the country, returns to producers whose prices were based on the prices of butter and powder continued to be higher while returns to producers in major cheese production areas were lower. This has resulted in the value of milk used in butter and nonfat dry milk greatly exceeding the value of milk made into cheese.

Adjusting The Purchase Prices Under The Federal Dairy Price Support Program Would Make Domestic Milk Protein Products Competitive With Imported MPC

The high dairy price support program purchase prices for nonfat dry milk have actually led to increased

imports of milk protein concentrates (MPC). At the current USDA purchase price for nonfat dry milk, it is more economically attractive for U.S. processors to turn milk into nonfat dry milk for sale to USDA than to manufacture MPC's to meet a wide variety of domestic uses.

Instead of increasing import tariffs as has been proposed in recently introduced legislation, a better and more immediate way to decrease demand for these imports would be to adjust the tilt in the butter-powder intervention prices. An adjustment to the tilt would provide new economic incentives for domestic milk processors to manufacture more MPC within the United States.
For example, a decrease in the purchase price of nonfat dry milk (NFDM) by 10 cents per pound from its current level of $1.0032 per pound with an offsetting increase in the purchase price of butter from its current level of $0.6549 per pound to $0.8486 would still maintain a $9.90 farm milk price as required by law, and also lead to lower imports of MPC. While this would result in some near term impact on producer prices, in the longer term, producers would gain through stronger markets and more price stability. Current market conditions show dairy farm prices strengthening (see Attachment 1, page 11), so this would help mitigate these short term impacts.

Nonfat dry milk that is currently being produced and sold to USDA is not a perfect substitute for MPC due to unique functional properties of the latter in a wide range of processed foods. However, U.S. companies already produce MPC in liquid, concentrated form, and we believe that the farm milk solids currently being purchased by the federal government in the form of nonfat dry milk could be put to better use serving the market demand for functional milk proteins in the form of MPC.

The following table shows that on a price-per-pound-of-protein basis, domestically produced nonfat dry milk and MPC (at 60% protein) are about equal.

		FOB US price per pound of protein
US nonfat dry milk at current CCC prices		$2.81
US nonfat dry milk with $0.10 tilt removed		$2.53
MPC (at 60% protein)	$2.54	

Dairy Price Support Program Has Fueled Regional Milk Price Distortions

The operation of the dairy price support program during the past two years, coupled with changes made

as a result of reforming federal milk marketing orders, have greatly increased regional differences in milk prices paid to producers. The government purchases have distorted the relative value of farm milk used to make nonfat dry milk and butter versus that used to make
cheese (see Figure 1). This has implications for federal order milk pricing which, since January 1, 2000, has used the higher of the nonfat dry milk/butter price or the cheese price to value milk used in fluid dairy products. In fact, the federal order minimum price for milk used in fluid dairy products averaged more than $2 per hundredweight of milk higher in calendar year 2000 under this pricing mechanism than would have been the case under the pricing regulations in effect prior to 2000. This has greatly increased the regional differences in farm milk prices.

The impact of the current USDA dairy product purchase prices on federal order prices is readily seen by comparing the relationship between farm milk prices in Wisconsin and Florida (see Figure 2). In Wisconsin, nearly 80% of farm milk is used to make cheese, a Class III product, while in Florida only about 2% of the farm milk ends up in cheese. This means that 98% of the farm milk in Florida benefits from the higher price created by the current USDA dairy product purchase prices. Therefore, the difference between farm milk prices in Florida and Wisconsin has increased by more than $1.00 per hundredweight of milk as a direct result of these misdirected government actions.

The increased difference between the price paid for milk used to make cheese versus that used in fluid milk products has created an incentive for cooperatives and individual dairy producers to ship their farm milk long distances to share in the pooled receipts from the higher valued milk. This is driven by the combined effect of the operation of the dairy price support program and federal milk marketing order reform. Prior to federal order reform implementation, the average difference between the Class I and Class III milk prices was equal to the average Class I differential. Since January 1, 2000, this average difference has grown by nearly $2.00 per cwt due the current USDA dairy product purchase prices. (see Figures 3A and 3B)

In addition to the impact on government costs and federal order milk prices, the dairy price support program as currently operated has priced nonfat dry milk out of the world market during a period when the U.S. could be competitive. Currently, world market prices are only a few cents below the USDA purchase price. This is especially true since the outbreak of Foot and Mouth Disease in the European Union, as many international customers are reluctant to purchase dry milk products from the E.U. and are looking for alternative sources of supply. In fact, the last bid accepted by USDA under the Dairy Export Incentive Program (DEIP) on April 2, 2001 only required a subsidy of 2.6 cents per pound of

nonfat dry milk, meaning it would take very

little adjustment in our nonfat dry milk prices to be competitive in world markets[1].

Forward Contracting Of Milk Regulated Under Federal Orders

Forward cash contracting is a simple tool which allows processors to offer producers or their cooperatives a set price for their milk over a specified period of time. Producers can voluntarily accept a pay price based on the offer or continue to receive pay prices based on the price set each month under the federal order program. Forward contracting lets both the producer and the processor know what the price is going to be in advance, so that both have a more predictable basis for planning their investments, financing, and business growth. This is especially important given the increase over time in the variability of milk prices (see Figure 4).

Producers of other commodities rely on forward contracts. According to a report by the General Accounting Office, forward cash contracting is the risk management tool most frequently used by producers outside the dairy sector. A majority of cotton (76%), corn (65%), and wheat (57%) producers used forward contracting to lock in their prices and revenues.

Dairy cooperatives can offer their producer members forward contracts, but the Agricultural Marketing Agreements Act of 1937 severely limits proprietary processors from offering producers forward pricing. Dairy producers thus can and often do choose to lock in their feed and other input costs through forward contracts, but many of them cannot lock in the price and revenue side of their market activities.

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[1]A total of 128 million pounds of nonfat dry milk received DEIP subsidies since January 1, 2001, with an average subsidy of only 5.5 cents per pound of nonfat dry milk. Those who argue that the U.S. could not sell into the world market even if purchase prices under the dairy price support program were adjusted are ignoring the fact that other countries have allowed U.S. companies to sell into the world market a significant quantity of nonfat dry milk purchased at the U.S. market price (about $1.01 per pound) with less than 6 cents in export subsidies.

In 1999, Congress took a first step by passing legislation to set up a dairy forward contracting pilot program. This program allows broader use of forward contracting between milk buyers and sellers as a tool to even out monthly and seasonal price swings. However, the 5-year pilot program specifically excludes buyers and sellers of milk that is bottled as beverage milk under Federal Milk Marketing Order regulation (known as Class I milk). This exclusion prolongs inequities in milk markets between certain milk buyers and sellers.

Since the dairy forward contracting pilot program went into effect, however, farmer use has been much greater than anticipated. Farmer contracts with cooperatives have increased as well and continue to expand. A typical contract is a year in length (some are longer) because this provides the ability to smooth out seasonal fluctuations in price that would otherwise occur. The farmer can then forward contract for feed ingredients, typically the largest cost input, and go to his or her banker with these contracts as evidence of income and margin stability. This improves the producer's ability to get loans for capital improvements for compliance with environmental regulations, equipment purchases, etc.

Policy Recommendations

We believe it is essential to take dairy compacts off the table so that a dialogue about a national policy can be seriously engaged. A large number of dairy producers have been convinced that dairy compacts are the best way to get more money, but this is only a very short term promise, at best. The facts from the operation of the dairy compact in New England demonstrate many flaws with this policy option. Since interstate compacts, including the dairy compacts, clearly come under the jurisdiction of the Judiciary Committee, we have not addressed the issues surrounding them in detail in this statement, but we would be happy to meet with members of the subcommittee to discuss our concerns.

New Safety Net For Producers

Instead of new regional programs on top of the federal programs already in place, we advocate that the dairy price support program be replaced with a safety net program for dairy producers which minimizes interference in dairy market prices and encourages global competitiveness of the U.S. dairy industry. There are options as to how this might be done. We suggest consideration of a program to protect dairy producers' margins between their largest input cost, which is feed, and the price they receive for their milk (see example of how this program might work in Attachment 2, page 12). This approach has

some similarities to the supplemental payment program advocated by the National Milk Producers Federation and to target price programs being discussed for other commodities.

As an interim measure, we would reluctantly support continuation of the dairy price support program through 2002, provided that the price support level remains at $9.90 per cwt and that USDA adjust the product purchase prices to better align with current market conditions. This will minimize market distortions that are currently occurring, provide new market possibilities internationally, foster growth of our domestic production of MPCs and decrease government costs.

Improved Risk Management Tools

One of the most important improvements that government can facilitate is providing more opportunities for producers and processors to work together to manage milk price risk through market tools, such as forward contracting and futures markets. We support authority for permanent forward contracting for all buyers and sellers of milk regulated under Federal orders, including Class I. The prohibitions on forward contracting for Class I milk should be removed for the duration of the pilot program so the impacts of providing the same benefit for Class I can be tested.

Producer Assistance For Environmental Compliance

We are prepared to join with producers in support of programs that encourage and assist dairy producers in development of best management practices to be better stewards of the land and support the development of reasonable and predictable, science-based standards to meet environmental goals. This is very important to assure the development of adequate milk supplies and to assure the competitiveness of the U.S. dairy industry globally. The U.S. industry can not afford to allow others to become lower cost producers while stalemating the continued development of a very competitive dairy industry in the U.S.

Dairy Industry Success Requires A More Cooperative Effort Among All Industry Players

We appreciate that the Chairman and members of this subcommittee all want to see a prosperous dairy industry. That is also, obviously, the interest of our member companies and of dairy producers. A clear understanding of how the dairy industry works today, however, is essential as a backdrop for consideration of policy changes that will achieve a more prosperous future.

Producers, processors, retailers and food service outlets, as well as consumers, are all essential parts of a successful dairy industry, so all of these interests' concerns should be considered in developing policies that will shape the future.

The dairy industry is primarily domestic, with 95% of our products relying on sales to U.S. consumers. Fluid milk consumption suffers from a slow per capita decline as the marketplace is bombarded by new, innovative products that are luring away milk drinkers at an earlier age than ever before. Ice cream sales have been relatively flat, facing increased competition from other snacks and desserts. Cheese has been the real growth area with new uses in foods, ready to eat dinners, pizza, ethnic and fast foods. The story here is that our member companies are competing not only with each other, but with many other beverages and foods that are available in a wide variety of outlets. Product innovation and marketing are key to meeting this competition. Efforts by the dairy industry to deliver products which consumers want and will purchase are hindered by federal dairy policy which artificially increases the cost of milk ingredients for such products. Recent policies have had the largest increased price impacts on milk used to make those dairy products which have seen at best stagnating demand, fluid milk products and ice creams and other frozen dairy products.

At one time our principle outlet for all dairy products was the grocery store, but that has changed substantially as our markets have become both more complex and more competitive. Rapid growth of superstores and club stores, dramatic increases in away-from-home eating, and the greater use of dairy ingredients in a variety of foods from those in the pizza parlor and fast food restaurant to the fix-in-a-hurry microwave dinner have changed the processing and distribution of dairy products dramatically. New competitors such as warehouse and club stores have forced consolidation of traditional food retailers in order for them to reduce costs and remain competitive. These new, more national retailers are demanding national suppliers with the ability to integrate supply systems through use of innovation and technology. This, in turn, is driving more consolidation in the food and dairy processing business in order to meet the demands and expense of innovation.

At the same time, dairy farmers and their cooperatives have grown larger to better compete and provide the milk needed for the many processing and manufacturing needs. The dairy producers also face greater costs per unit and are restructuring their business to adjust input use and scale of operation in response. Capital investments are needed to comply with environmental and health and safety regulations, and to invest in technology necessary to stay cost competitive. These cost pressures are

driving expansion of large producers while small producers continue to decline.

These market facts have brought producers and processors together in advocating expansion of trade for dairy products and in promoting their products through the producer and processor funded check off programs. Collaboration here has spurred packaging, product and ingredient innovation, and more is to come. For instance, a recent pilot project placing milk vending machines in 100 schools shows milk companies can compete head on with sodas and other beverage choices if products are exciting, good tasting, and capture kids' imaginations.

More needs to be done in marketing and opening markets, but policies must not add unnecessary costs to the marketing system. In addition, policies should promote tools such as forward contracting to allow this growth to occur through industry partnerships with producers and processors. Dairy processors and manufacturers need dairy producers as strong partners, but the reverse is also true. Government policies should enable, not impair, that partnership possibility.

Attachment 1: Current Dairy Market Situation

High farm milk prices and low feed prices in 1998 and 1999 led to growth in milk production outpacing growth in demand for milk and dairy products. This oversupply relative to demand led to the low dairy commodity and farm milk prices of 2000 - evidence that the marketplace works (high prices and profits stimulate additional production).

The low farm milk prices of 2000 have been a cause for concern by farm groups and even by policymakers. The former because they are impatient for the markets to signal dairy producers to reduce milk production and for the same low price signals to entice consumers to increase the amount of milk and dairy products they purchase. The latter because they seem to lose faith in dairy markets every time farm milk prices turn down (they never seem to have the same problem when farm milk prices are high).

In fact, the low milk prices and lower (than the relatively high levels in 1998 and 1999, but not low by historical levels (see Figure 5) income over feed costs in 2000 did have an impact on the dairy markets. Contrary to the myth often repeated by dairy producers, milk production has declined significantly due to lower milk prices and reduced profitability. The trend seen between early 1998 and mid 2000 of growth in milk production outpacing growth in demand has reversed in the past nine months. Once again, strong, irrefutable evidence that dairy markets work.

One problem with analyzing dairy policy proposals with existing analytical tools is that those tools largely are based on the many years when existing dairy policies have had significant impacts on the dairy markets. For instance, in February 2001 USDA forecasted that farm milk prices would remain relatively low for most of the coming year. Even so, USDA's January estimate of the farm value of milk production for CY2001 was $1.02 billion higher than the actual value of milk production in CY2000. However, actual prices paid to dairy producers through April, combined with milk futures market prices for the rest of the year and USDA's most recent estimate of CY2001 milk production, forecast that the farm value of milk production in CY2001 will be $2.125 billion higher than in CY2000. This is even $720 million higher than the value of farm milk production in CY1999, when surging milk production led to the low farm milk prices seen in CY2000.

In addition, dairy producers are receiving Market Loss Assistance payments (as required by Congress last fall). These payments amount to nearly $0.65 per hundredweight, with a cap of 39,000 hundredweights per farm (over $25,000 per farm). USDA estimates these payments will total over $650 million. This amount was calculated late last year by USDA based on USDA's forecasts of milk prices for CY2001. In fact, if USDA were to make the same calculation with data available today, the forecast of CY2001 milk prices would result in **no** Market Loss Assistance payments this year.

Attachment 2: Concept For A Dairy Producer Margin Assurance Program

Policy Objective: Provide dairy producer income protection without price intervention. *This program could be structured to operate either as a direct payment program or as a commercial insurance program, either fully funded by market premiums or a combination of public funding and market premiums.*

Government will guarantee dairy farmer income at a specified percentage of the gross margin, defined as the difference between the milk price and feed costs. Authority will be provided to the Secretary of Agriculture to annually adjust this percentage of gross margin support at a level within a specified range (80 to 90 percent).

- The Secretary of Agriculture will establish regions for this program as well as identify the milk price and feed cost formulas to be used. The Secretary of Agriculture will then announce the milk price, feed price, and resulting gross margin for each region quarterly. In addition, the Secretary would announce the historical average gross margin for each region as the five-year, moving average (discarding the high and low gross margins).

- Dairy farmers would be eligible to receive margin support payments when the gross margin for that region in that quarter falls below the gross margin support level announced by the Secretary of Agriculture. If the actual gross margin is greater than the gross margin support level, no payments would be made.

- Examples (applicable to each region for each quarter):

Assume announced percent of gross margin of	90%	
Assume historical average milk price of		$14.00
Assume historical average feed costs of	$ 6.00	
Calculated historical gross margin of		$ 8.00
Announced gross margin support level of	$ 7.20	

Example 1: High feed costs relative to historical average

Actual milk price of	$14.00
Actual feed costs of	$ 7.00
Actual gross margin of	$ 7.00

Payment to dairy farmers for the quarter would be $0.20 per cwt for all milk marketed during

the quarter in that region.

Example 2: Low milk price relative to historical average

Actual milk price of	$12.50
Actual feed costs of	$ 6.00
Actual gross margin of	$ 6.50

Payment to dairy farmers for the quarter would be $0.70 per cwt for all milk marketed during that quarter in that region.

If USDA had adjusted the dairy product purchase prices in late 1999 in response to rapidly increasing government purchases of nonfat dry milk, the increased difference between Class I and Class III milk prices would have been much smaller following implementation of Federal Order Reform.